City of Detroit

CITY COUNCIL

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TO: COUNCIL MEMBERS

FROM: Irvin Corley, Jr., Director ICJ.

DATE: February 23, 2010

RE: Resolution Authorizing the Sale of $250 Million in Fiscal Stabilization Bonds, ***Line Item 63 on today's Formal Session Agenda*** **(Recommend Approval)**

Introduction

Last week, the Finance Department presented to your Honorable Body for consideration a resolution authorizing the sale of not to exceed $250 million in fiscal stabilization bonds. I thank the Administration for responding to my questions on this sale.

Previously, a municipality in the State of Michigan could sell only up to $125 million in fiscal stabilization bonds. However, on February 4, 2010, both the House and Senate passed legislation allowing for a sale up to $250 million in fiscal stabilization bonds. This limit only applies to the period from January 1, 2010 to September 1, 2010, clearly for the benefit of the City of Detroit. Governor Granholm signed the legislation into law (i.e., Public Act 4 of 2010) on February 5th.

On February 16th, the State Administrative Board (the "board") authorized the City of Detroit to sell up to $250 million in fiscal stabilization bonds. In accordance with PA 4 of 2010, the Administration submitted to City Council in November a statement signed by Mayor Bing indicating how the City intends to avoid future deficits. A copy of this statement was also shared with the board. In addition, a copy of a deficit elimination plan, received by Council in November, was also submitted to the State Treasurer and the board showing how future deficits would be addressed.

Role of the Fiscal Stabilization Bonds

To remind the Council, the deficit elimination plan showed an accumulated deficit of $326 million as of June 30, 2009. The purpose of the fiscal stabilization bonds is to finance the accumulated deficit of $220 million as of June 30, 2008 **over 25**

years, the proposed amortization period of the bonds, if approved by City Council.

Council should note that the State Treasurer approved the City's deficit elimination plan; which of course includes the use of bond proceeds to help fund the deficit.

<u>Characteristics of the Fiscal Stabilization Bonds</u>

The Finance Department assumes the bonds would have a par amount of $250 million; the bonds would be issued with an original issue discount, thereby netting aggregate proceeds of approximately $245 million. If the City purchases bond insurance, the cost of issuing the bonds could range between $2.5 to $5 million. At this time, Finance assumes no bonds monies would be set-aside in a debt service reserve account. There is no refunding (refinancing of existing bonds) component to this proposed bond transaction.

If it is not economically feasible to purchase bond insurance, and if the City would be required to fund a debt service reserve account, which usually amounts to a given year's principal and interest requirement, then the net proceeds of the bonds would be lower. However, it is assumed that there should be sufficient funds to finance the $220 million accumulated deficit as of June 30, 2008, which of course is the main purpose of the bonds.

Under the current municipal bond market, and assuming the bond sale receives strong ratings from the rating agencies, the interest rate on the bonds could be less than 6%, and the rate would be fixed.

Council should note that the City does not intend to enter into any interest rate swap agreements in connection with the fiscal stabilization bonds. That is good news, since the City does not always end up in a favorable light with these agreements depending on market conditions; as shown last year when a huge termination payment was potentially due associated with the interest rate swap agreements in connection with the Participation Obligation Certificates for the pension systems. Fortunately, the City was able to work out a deal to avoid a huge one-time termination payment.

It is also important to note that should the Finance Director ever look to negotiate an interest rate swap agreement with respect to the bonds with interest rate exchange agreement providers, such negotiations must be "confirmed by the Council by resolution". This language is located on page 25 of the bond resolution under Section 901, subsection (c). So in essence, any interest rate swap agreement entered into by the Finance Director would have to be approved by City Council.

Salability of the Fiscal Stabilization Bonds

Finance feels the bonds could receive strong ratings because the bondholders or investors would have a first lien on the City's state revenue sharing dollars that would be pledged to pay off the bonds, in accordance with PA 4 of 2010.

On average, the annual debt service requirement should be around $20 million over the anticipated life of the bonds, or 25 years; so the bonds would mature around 2035. The City's receives around $60 million annually in "constitutional" state revenue sharing dollars. So, the bondholders should feel comfortable that there is a 3 times coverage ratio to pay back the bonds. Currently, the City expects to receive approximately $180 million in "statutory" state revenue sharing dollars, which is the more vulnerable pot of money subject to reduction, given the State's budget situation. But fortunately, so far Governor Granholm has expressed her reluctance to impose further cuts on state revenue sharing dollars to help balance the State's budget for fiscal 2010-11.

There is a note of caution here. The current amortization schedule Finance shared with Fiscal Analysis shows zero principal payments for the first four years, and escalating principal payments for the remainder of the amortization period, especially towards the back end of the 25 years. Although the City has structured bond sales like this in the past, it puts more pressure on the City to pay debt service towards the end of the amortization period.

The salability of the bonds should also be strong since the State Treasurer is to send the necessary amount of state revenue sharing dollars to cover annual debt service payments directly to a trustee, as allowed under PA 4 of 2010. Finance also indicated that the State Treasurer has agreed not to withhold any state revenue sharing payments necessary to set-aside requirements on the bonds. The City had a similar arrangement under the Greater Detroit Resource Recovery Authority bonds, which were backed by state revenue sharing dollars.

In addition, the fiscal stabilization bonds are backed by the full faith and credit of the City, so any deficiencies in state revenue sharing to cover debt service would be made up with another source of revenue; probably property taxes. But this scenario is highly remote.

The City's Continual Budget Deficit Challenge

One would think a fiscal stabilization bond sale is the next best thing to sliced bread, but it is not. The issuance of fiscal stabilization bonds is similar to a person refinancing his or her mortgage to cash out on the equity in the house to pay off current bills and credit cards, with the plan to streamline spending and reduce or eliminate current debt. Of course, the risk is that the person continues to spend as before and open up other debts, thereby falling back into a bad financial situation, if not worse.

Ideally, the Administration would produce an updated deficit elimination plan to reflect the current status of items in the plan. For instance, major revenue declines could be higher given the economy, and the City would have to come up with other cost savings plans if the savings initiatives do not fully materialize by the end of the current fiscal year and revenues have declined further.

The Administration indicated the State Administrative Board does not require an updated deficit elimination plan. However, Finance stated that any modifications needed to the deficit elimination plan would be included in the City's proposed 2010-11 budget Mayor Bing will present to your Honorable Body probably on April 13th.

However, to the best of my ability, I have updated the deficit elimination plan based on our latest budget estimates and my review of support documentation housed in the Finance Department (i.e., spreadsheets, information from the emergency collections contractor, trustee statement, grant documentation, Human Resources reports, etc.), coupled with a recent Council action on the Greektown Casino bankruptcy settlement.

The information below reflects the fact that the City is three months into the deficit elimination plan and the following items have been completed realizing the numbers in the plan: layoffs, some budgeted furlough days, Cobo regionalization, delinquent receivable collections, Greektown Casino bankruptcy settlement, state revenue sharing payment and DDOT grant funding. In addition, some savings will be realized from the fringe benefit changes your Honorable Body recently approved.

FY 2009-10 Updated Deficit Elimination Plan Analysis

(in millions)

	Original Plan per Admin.	Updated Plan per Fiscal Ana.
Accumulated deficit as of June 30, 2008	($220.00)	($220.00)
Fiscal Stabilization Bonds	230.00	230.00
FY 2008-09 Estimated Operating Deficit	(106.00)	(109.10)
FY 2009-10 Revenue Shortfall		
- State Revenue Sharing	(29.00)	(40.10)
- Income Tax	(32.00)	(31.00)
- Utility Users' Tax	0.00	(5.00)
- Casinos (Wagering Tax)	(5.50)	(7.50)
- Property Tax	(2.50)	(3.00)
- All Other Revenue	0.00	(73.00)
Appropriation Projections	0.00	24.90
Total Operating Shortfall	($165.00)	($233.80)

Savings Item		
Layoffs	7.35	3.70
Budgeted Required Furlough days	7.40	4.20
Cobo regionalization	11.25	11.75
Delinquent receivable collections	3.00	3.48
Greektown Casino bankruptcy settlement	8.00	8.00
State Revenue Sharing payment	23.00	24.40
DDOT grant funding	13.00	16.00
Crisis Turnaround Team initiatives:	15.00	
- BCBS health care credit		4.70
- DTE settlement approved by Council		3.00
- Contractual reductions due to furlough days		1.20
GDDRA-DTE Escrow settlement	20.00	0.00
Office of Restructuring: $10 million savings originally est.	0.00	0.00
Fringe benefit changes, only 5 months worth in FY	0.00	1.80
Total Savings realized in FY 2009-10	$108.00	$82.23
Accumulated Deficit as of June 30, 2010	($57.00)	($151.57)

Meanwhile, the Administration continues to work on the GDDRA-DTE escrow payment, budget required furlough days, Crisis Turnaround Team recommendations and Office of Restructuring initiatives. Finance feels more savings can be generated from delinquent receivable collections. In addition, the Administration is apparently real close to finalizing the GDDRA-DTE escrow payment deal, and details could be submitted to Council within three weeks.

As a result, I suspect the proposed 2010-11 budget could still have a sizable prior year or accumulated deficit. Rather than being $47 million as indicated in the original deficit elimination plan, the accumulated deficit as of June 30, 2010 could total about $151 million (or about $130 million, if the GDDRA-DTE escrow payment materializes this fiscal year).

But this would still be a huge improvement in the City's overall deficit picture. And the Administration has repeatedly said the deficit would take more than one year to cure, which we agree. In fact, the original deficit elimination plan is a three-year plan to address the City's operational deficit.

At any rate, the upcoming budget must include some hard choices proposed by the Administration to address the City's structural deficit.

Impact of Fiscal Stabilization Bonds on the City's Cash Flow

My review of the City's cash flow statement indicates that with the infusion of $230 million in fiscal stabilization bonds, the City would have sufficient cash to meet the City's obligations and avoid payless paydays this fiscal year. In addition, the cash flow does not anticipate any short-term borrowings for the remainder of this fiscal year. Therefore, with the infusion of the proceeds from the bonds, the Administration feels the City would be in a position to implement the structural changes needed to bring long-term financial stability to the City.

Unfortunately, the City cannot rule out another short-term borrowing this year, if revenues come in lower and a sizable portion of the savings initiatives does not materialize and alternative cost cutting initiatives cannot be implemented this fiscal year. Currently, the Finance Department still has authorization to float a short-term tax anticipation note up to $58 million, if necessary. But at this point, the Administration vehemently feels it can avoid another short-term borrowing this fiscal year.

Conclusion and Recommendation

It is clear that the State legislature and Governor have confidence in the Bing Administration and your Honorable Body to address the City's current budget crisis by enacting legislation that provides an eight-month window to issue up to $250 million in fiscal stabilization bonds to help address the City's accumulated budget deficit.

As contemplated, the State Treasurer would transmit sufficient state revenue sharing dollars directly to a trustee as a first lien obligation to pay off the bonds. This scenario would significantly add marketability to the bonds.

The issuance of fiscal stabilization bonds is not a panacea; they do not eliminate a deficit, but help to pay it off over a longer period of time, in this case, 25 years, if your Honorable Body approves this bond sale.

With the Council's help, the Administration has made good strides in helping to address the City's budget structural deficit. More savings need to occur this fiscal year, however, to avoid an accumulated deficit up to $150 million by the end of this fiscal year.

Based on the above analysis, I recommend that Council approve the resolution to issue up to $250 million in fiscal stabilization bonds this week. This would significantly help the City to meet its obligations the rest of this fiscal year, possibly avoid more short-term borrowing this fiscal year and provide the City additional time, probably a year or two, to make the necessary adjustments in the City's cost structure and possibly generate more revenues to ensure long-term financial viability of the City of Detroit moving forward.

cc: Council Divisions
Auditor General's Office
Norman White, Chief Financial Officer
Tom Lijana, Group executive-Finance

Donita Crumpler, General Manager-Finance
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